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Warning: Asset bubbles are underway

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"Bubble, bubble, inflate and trouble." Macbeth's witches would surely be chanting this incantation at the spectre of the frantic efforts of central bankers to re-inflate the economies of the developed world. Both the Federal Reserve and the European Central Bank have stepped up their quantitative easing, essentially printing money by buying government bonds.

The result is a world awash in cheap money. Unfortunately, cheap money is the witch's brew that fuels asset bubbles which, following their inevitable crashes, are so devastating to so many investors. The U.S. housing price bubble is the most recent example of a manic cycle created by easy money. In the late 1990's, the massive run-up in the price of technology stocks in the dot.com boom was abetted by the Fed's flooding the world with cheap dollars during the Asian crisis. Even the epic Japanese stock and real estate bubble of the late 1980's was fuelled by easy credit policies.

Bubbles and crashes can vary widely as to asset, geography, duration, and severity but - as economist Hyman Minsky noted - they follow a predictable pattern. Every bubble begins with a displacement, a new phenomenon in the economy that begins to attract and excite investors. The Internet that gave birth to the tech boom is the classic example. The rise of OPEC in the 1970's which fostered the energy bubble is another. Today, the rise of China and its impact on commodity prices is the leading displacement.

The second stage is expansion; as investment dollars pour into the new opportunity it is soon transformed into a boom. The investment industry jumps in with a deluge of new products. Think of oil and gas drilling partnerships in the 1970's, Japanese equity mutual funds in the late 1980's and technology funds in the 1990's. Like throwing gasoline on a fire, easy money accelerates the flow of investment further escalating prices.

At some point, the boom becomes euphoric. Increasingly, projects are marginal - oil drilling in the Arctic, unneeded skyscrapers in Tokyo or firms like Pets.com. Yet, prices keep rising and more investors flood in as speculative fervour becomes rampant. Critics, often value investors, are viewed as anachronisms.

Ultimately, the apex is reached. As prices first crack and then freefall, panic sets in. Virtually overnight, fear replaces euphoria. Distress is everywhere as the final stage, aptly named, revulsion, sets in. Losses are legion, particularly for the late entrants. Paradoxically, these later buyers are often the more conservative types who finally capitulated to the lure of the mania. As the economist Charles Kindleberger famously stated. “There is nothing so disturbing to one's well-being and judgment as to see a friend get rich.”

There is no question that currently, precious metals and commodities are the leading candidates to turn into asset bubbles. Gold prices and commodity producer stocks are up over 450% and 250%, respectively, since January 2000, a stunning contrast to the negative return of the U.S. stock market. Characteristically, we are now seeing an explosion in new precious metal and commodity funds.

Yet, asset bubbles can take many years to reach a crisis. Oil took the better part of a decade to hit its peak in the early 1980's. Alternatively, they can ebb away - this might occur if China's economy slows down or real interest rates rise quickly. Right now, however, warning signs are appearing.

Investors need to aware of the almost irresistible lure of asset bubbles. The best defence is adhering to an asset mix based on a sound, long-term strategy while ignoring the bragging of bubble chasers. Trust me, it will end badly for them - it always does.

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